

**Office of Chief Counsel
Internal Revenue Service
memorandum**

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to: Kathy Sexton
Technical Services Group Manager
(Small Business/Self-Employed)

from: Blaise Dusenberry
Senior Technician Reviewer
(Procedure & Administration)

subject: IRC Section 6501(e) Question

This memorandum responds to your request for advice.

ISSUE

Are amounts received or accrued reduced by returns and allowances when determining gross income for purposes of I.R.C. section 6501(e)(1)(A)(i)?

CONCLUSIONS

When determining gross income for purposes of I.R.C. section 6501(e)(1)(A)(i), the total amounts received or accrued from the sale of goods or services should not be reduced by returns and allowances.

FACTS

You have requested assistance on the manner in which a taxpayer accounts for returns and allowances in determining gross income for purposes of I.R.C. section 6501(e)(1)(A)(i). Section 6501(e)(1)(A) provides that if a taxpayer omits from gross income an amount properly includible therein which is in excess of 25 percent of the amount of gross income stated in the tax return, the tax may be assessed, or a proceeding in court for the collection of such tax may begin without assessment, at any time within 6 years after the return was filed.

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Section 6501(e)(1)(A)(i) specifically addresses cases involving a trade or business and includes a special rule for determining gross income. Under this subsection, gross income is defined as the total of the amounts received or accrued from the sale of goods or services (if such amounts are required to be shown on the return) prior to diminution by the cost of such sales or services. Returns and allowances (and other income) are not specifically mentioned. You have asked if in a case involving a trade or business, a taxpayer's gross receipts and sales should be reduced by returns and allowances when calculating gross income.

In some cases, the 25 percent omission computation hinges on how to treat returns and allowances. For example, Exam may make adjustments in both gross receipts and returns and allowances. If gross income is determined by reference to gross receipts without subtracting returns and allowances, the omission does not exceed 25 percent. However, if returns and allowances are subtracted from gross receipts to determine gross income, without reduction for costs of sales, then the omission exceeds 25 percent and the six-year statute under § 6501(e) applies. The following chart illustrates this scenario:

	Per Return	Per Exam	Adjustment
Sch C Gross Receipts	500,000.00	600,000.00	100,000.00
Returns & Allowances	(50,000.00)	(5,000.00)	45,000.00
"Net Gross Receipts"	450,000.00	595,000.00	145,000.00
25% of Gross Receipts at 500,000.00 is 125,000.00. The adjustment amount is 100,000.00. IRC 6501(e) would not apply.			
25% of "Net Gross Receipts" at 450,000.00 is 112,500.00. The adjustment amount is 145,000.00. IRC 6501(e) would apply.			

LAW AND ANALYSIS

In general, taxpayers who sell goods or provide services compute gross income through a basic computation. This computation results in gross income by subtracting returns and allowances and cost of goods or services and adding other income to gross receipts and sales. This computation is illustrated in IRS Form 1120, *U.S. Corporation Income Tax Return*, Form 1120S, *U.S. Income Tax Return for an S Corporation*, and Form 1040 Schedule C, *Profit or Loss From Business*. Tax Court decisions likewise acknowledge that gross receipts are reduced by returns and allowances in computing gross income. See *Friedmann v. Commissioner*, T.C. Memo. 2001-207 (Returns and allowances are taken into account in computing gross income and differ from expenditures that are business deductions.). Under the Internal Revenue Code and its

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corresponding regulations, returns and allowances are sometimes but not always subtracted to determine “gross income” pursuant to special rules and definitions.

Section 61(a)(2) provides, in part, that gross income means all income from whatever source derived, including gross income derived from business. Section 1.61-3 of the Income Tax Regulations provides that in a manufacturing, merchandising, or mining business, “gross income” means the total sales, less the cost of goods sold, plus any income from investments and from incidental or outside operations or sources. Thus, while cost of goods sold is subtracted from total sales to determine gross income, returns and allowances are not specifically mentioned in section 1.61-3.

A number of other Code provisions and regulations address the issue of whether a taxpayer reduces its gross income by the amount of returns or allowances for purposes of those sections. For example, section 41(c)(7), pertaining to the credit for increasing research activities, provides that gross receipts for any taxable year shall be reduced by returns and allowances made during the taxable year. Similar provisions that require a subtraction of returns and allowances from gross receipts include sections 44(d)(5) and 448(c)(3)(C). Section 1.263A-3(b)(2)(ii) provides that gross receipts does not include amounts representing returns or allowances. Likewise, section 1.448-1T(f)(2)(iv) provides that gross receipts include total sales (net of returns and allowances) and all amounts received for services.

There are also a number of regulatory provisions providing that gross receipts are not reduced by returns and allowances. For example, section 1.1244(c)-1(e) of the regulations provides that gross receipts are not reduced by returns and allowances for purposes of section 1244(c)(1)(C) (Losses on Small Business Stock) in determining whether a corporation’s stock is “section 1244 stock”. The same is true for section 1.1362-2(c)(4), which provides that gross receipts, for purposes of determining Subchapter S election status, are not to be reduced by returns and allowances, cost of goods sold or deductions.

The Tax Court has held that returns and allowances are subtracted from gross receipts to determine gross income. In Pittsburgh Milk Co. v. Commissioner, 26 T.C. 707 (1956), the taxpayer recorded sales of milk on its books at the authorized list prices set by the state but paid allowances, reductions and rebates back to some of its customers and entered them on its books as advertising to disguise the true nature of these payments. These allowances were made pursuant to informal agreements with its customers. The taxpayer contended that the allowances should be applied to reduce its gross receipts and sales on the theory that the milk was actually sold for the agreed net prices. The court looked to the agreement of the parties at the time of sale to determine the net sales price and held that any amount given back to the customer is considered an allowance not includible in gross income. Id.

The general definition of gross income and the statutes, regulations, and caselaw on the subject, however, do not apply for purposes of section 6501(e)(1)(A)(i). This section

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creates its own special definition for gross income by defining it as the total of the amounts received or accrued from the sale of goods or services, if such amounts are required to be shown on the return, prior to subtracting the cost of sales or services. This definition is synonymous with gross receipts and sales as the amount includes both money received and money due from sales during the taxable year (accounts receivable). There is no case law on point that definitively indicates whether this amount should be reduced by returns and allowances to calculate gross income for purposes of section 6501(e)(1)(A)(i).

Our determination that amounts received or accrued should not be reduced by returns and allowances is based on a plain reading of the statute. The specific language states “the total of the amounts received or accrued from the sale of goods or services (if such amounts are required to be shown on the return) ...” We believe that under a plain reading of the statute, the referenced amount is the amount reported on the business return as gross receipts and sales. See Bencivenga v. Commissioner, T.C. Memo. 1989-239 (For section 6501(e)(1)(A)(i), “[i]n the case of a trade or business ... gross income is the same as gross receipts undiminished by the cost of sales or services.”).

We have included below three examples to help clarify how returns and allowances are accounted for when computing gross income generally and for purposes of section 6501(e)(1)(A)(i). These examples illustrate: (1) a discount reducing gross receipts and sales, (2) an allowance reducing gross income but not reducing gross receipts and sales, and (3) a return reducing gross income but not reducing gross receipts and sales.

1. Business A sells 100 units with a “ticket” price of \$100 for \$80 each. The amount received or accrued from the sales of the units that is required to be shown on Business A’s return is \$8,000. The \$20 discount is not an allowance because the amount paid was \$80 not \$100. \$8,000 is reported on the line for gross receipts and sales but the \$2,000 is not reported on the line for returns and allowances.
2. Same facts as in example 1 except Business A sells all 100 units to Business B for \$100 each. At the time of the sale, Business A agrees to give Business B a \$2,000 rebate for buying all 100 units. Business B pays \$10,000 and then receives a check for the \$2,000 rebate. The \$2,000 rebate is an allowance on Business A’s tax return that reduces gross income but it does not reduce gross receipts and sales. \$10,000 is reported on the line for gross receipts and sales and \$2,000 is reported for returns and allowances.
3. Same facts as in example 1 except Business A sells all 100 units to various customers for \$100 each. Twenty customers subsequently return their units. Business A must report \$10,000 as gross receipts and sales (regardless of whether payment was received). The \$2,000 of returned merchandise is reported as returns and allowances thereby reducing gross income.

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The gross receipts and sales reported on Business A's return is the equivalent of the total amounts received or accrued from the sale of goods or services for purposes of section 6501(e)(1)(A)(i). The returns and allowances will reduce Business A's gross income on its tax return under the general rule for computing gross income. However, pursuant to the special definition of gross income under section 6501(e)(1)(A)(i), only amounts received or accrued are considered and returns and allowances must be disregarded (as well as cost of goods or services and other income). Accordingly, gross income for purposes of section 6501(e)(1)(A)(i) is gross receipts and sales.

Please contact Ron Goldstein at (202) 622-4910 if you have any further questions.